Dialogue on Globalization

BRIEFING PAPERS

FES NEW YORK

The Global Financial Crisis: What Needs To Be Done?

CHRISTOPHER RUDE

FRIEDRICH EBERT STIFTUNG

1 Background

On Thursday November 13, 2008, a group of expert academics, international regulators, bank representatives, policy makers, and trade unionists from the United States, Europe, Asia, and Latin America met in New York to discuss the global economic crisis, its causes and social effects, and its implications for banking and financial market regulation and governance. Nobel Laureate Joseph Stiglitz of the Initiative for Policy Dialogue (IPD) hosted the meeting, which was sponsored jointly by the IPD and the Friedrich Ebert Stiftung (FES). Attending the meeting were present and past senior economic authorities from Argentina, Brazil, Canada, China, Chile Colombia, Egypt, the European Union (EU), Germany, Malaysia, Poland, Spain, the United Kingdom (UK), and the United States (US), including Justin Lin, Chief Economist of the World Bank, Poul Rasmussen, head of the Financial Regulation Committee of the European Parliament, Y. V. Reddy, Governor of the Bank of India, Paulo Nogueria Batista, Executive Director for Brazil at the International Monetary Fund (IMF), Amar Bhattacharya, the Director of the G24 Secretariat, Philip Turner of the Bank for International Settlements (BIS), and Jose Antonio Ocampo and Stephany Griffith-Jones of the IPD. Federal Reserve Bank of New York Senior Vice President Christine Cumming gave the opening comments.

The ensuing discussions were frank and serious. Participants knew that the heads of state of the G20 industrial and developing countries were meeting in Washington two days later, and they wanted to influence the outcome of that meeting. They welcomed calls being made for a "Bretton Woods II," seeing fundamental financial reform as necessary for both economic and social stability. Some participants expressed concern that an enhanced Financial Stability Forum (FSF), together with the IMF, might be given the responsibility for promulgating these reforms based upon a limited agenda and without making the necessary changes in accountability and governance. Participants were also aware that the United Nations' Follow-up International Conference on Financing for Development would convene in Doha just two weeks after the G20 summit, and they wanted to strengthen any initiatives for fundamental reform – reform involving changes in institutions – that might come from there. The author participated in these off-the-record discussions.

2 Key Elements of Reform

Serious efforts to reform the international financial system must consider the broad lessons of the current crisis for financial market regulation, specific steps to take to make future financial stability more likely, and the reshaping of the international financial system, including its architecture and governance, so that it better serves the needs of the underlying real economy. Such efforts should begin with the recognition that the social costs of financial instability on the emerging market and developing economies – and on the poor and the working classes more generally – are immense.

Situation and diagnosis. The US "subprime" financial market meltdown is having severe adverse social effects on the developing world. Nations with well-ordered and regulated economic, trading and financial systems have been brought into the turmoil through its second- and third-order effects. Thus the crisis is no longer a US-centered financial crisis, but a global economic crisis. A crucial part of the problem is the interaction between the financial system and the "real" economy during the downturn. The diagnosis is simple: existing financial market regulation is pro-cyclical, inconsistent, outdated and incomplete, deficient in its concern for banks' short-term liabilities and liquidity needs, and based on the erroneous assumption that one can trust the markets' assessment of systemic risk.

Financial stability. To make future financial stability more likely, concrete steps must be taken to remove or at least abate the existing system's procyclicality, bring every institution, market, instrument, and economy under a clear and simple system of regulatory control, address banks' liquidity needs, and aggressively control systemic, aggregate market risk.

Dealing with the social costs. More is needed than just economic stability, no matter how important it is. The banking and financial systems of each country as well as the international money, credit, and capital markets that connect them – including their depth and stability and any profits that are being made – are means to an end, not ends in themselves. The social dimension of the present crisis raises questions that cannot be answered in terms of the market about the fairness of the existing regime. In order to produce social stability, reforms to the existing international financial architecture should address the needs and interests of the emerging market and developing countries that have been hurt by the turmoil originating in the United States, including the needs and interests of their working classes and poor.

Stimulus, other measures. Financial reform will not prevent the crisis from getting worse unless it is accompanied by coordinated fiscal stimulus and liquidity injections, the use of capital controls for counter-cyclical purposes, and IMF reform.

3.1 Facts Behind the Crisis

The current economic difficulties have a United States origin. The original underlying assets were houses whose prices were falling. The collapse of the securitized US mortgage market and its related derivative products amplified the weakness of the US housing sector, sending a contractionary shock through the US economy and to the rest of the world.

Asset backed commercial paper issued by the special purpose vehicles now in trouble brought weakness to the dollar funding market, causing it to freeze up in August 2007. This market provides large US and foreign multinational financial conglomerates with the short-term monies that they need to finance their investments, including those made daily on their trading floors. It has been more or less frozen ever since, with disastrous consequences for the larger financial system.

Its complete shutdown in August 2007 crippled the US banking and financial system, causing it to slowly unravel. Matters got worse in September 2008, or rather, matters came to a head. Little new had happened within the core of the financial system itself, for it had already come to a halt, but the general macroeconomy was weakening and pulling asset prices further down.

A classic macro-driven debt deflation was underway: the freeze-up spread from the interbank to the other short-term US money markets, including those controlled by the major money market mutual funds, causing them to freeze up as well. By November 2008, the entire financial system, and not that of just the money markets of the United States or the United Kingdom, became incapable of carrying out even the simplest of steps involved in the conversion of corporate savings into investment or the financing of home building, personal consumption, or development. Under present arrangements, raising the funds necessary to improve and green the world's infrastructures is very difficult.

3.2 Perspective of the Developing World

Emerging market and developing countries at first seemed immune from the turmoil coming from the United States. Lags in the contraction of the US's and Europe's import demands, a sharp increase in energy and commodity prices (some of it driven by the move of speculative monies out of the collapsing US mortgage and credit markets) and the reserves that many emerging market and developing countries had accumulated in recent years gave them a temporary reprieve. This immunity did not last long. Soon, countries that had adopted export-led growth strategies and liberalized their capital accounts, found that they were suffering from the effects of a reduction of the aggregate demand of the nations to which they exported.

They were also affected by a sudden and very large rise in their interest rates in the wake of the implosion of the US financial system in September 2008. These economies are thus suffering from an economic crisis of their own (expressed in falling exports, falling commodity prices, and declining domestic demand) but through no fault of their own. The same price rise that contributed to these countries' temporary reprieve had another, negative, effect as well: sharply rising corn, rice, grain, and other food prices produced a sudden and large fall in real wages and living standards, which was not subsequently ameliorated by the later price declines. This was happening just as unemployment was on the rise. Emerging market and developing countries are now suffering from the same vicious circle that is affecting the developed nations: their weakening economies are interacting with weaknesses in their financial systems. A global debt deflation is underway.

3.3 Political Implications for Development

The political implications of this for emerging market and developing countries are as important as the economic effects. Today's crisis originated in the United States, the country that until now was one of the major authors of financial market deregulation. It affected developing countries from the outside (countries that had also been deregulated from the outside). Contrary to the Asian financial crisis, therefore, calls for the creation of new and different international financial institutions are strong. The United States investment banking model has been discredited, together with its simple reliance upon the corrective powers of the financial markets. No wonder many emerging market and developing countries are calling for a "Bretton Woods II" meeting to establish a new and more globally just kind of international banking and financial system.

4.1 Financial Market Reform Measures

What went wrong economically?

- The banking regulations promulgated by the Basel Committee on Banking Regulation, with its emphasis on minimum capital requirements, light supervision, and market discipline, are pro-cyclical: they encourage investors to make larger and riskier investments during the upswing of the business cycle and to cut back in their investments during the downturn, increasing rather than damping the instability of the financial markets and the volatility of the underlying real economy.
- Existing regulations have not kept up with changes in the banking and financial system. They also encourage regulatory arbitrage and allow banks and other financial institutions to hide their activities from regulators using off-balance sheet legal entities, complex derivative instruments, and off-shore financial centers.
- Securitization, credit derivatives, and the move from a bank-centered to a market-centered financial system in general have clearly played a role in the crisis. But the financial turmoil, when it appeared, appeared in the large banks and investment houses, or more precisely, in the short-term money markets in which these institutions at the core of the global economy raise the short-term monies that they use to finance long-term investments. The problems are on the liability rather than the asset aide of their balance sheets and concern their inability to roll over short-term debt rather than the riskiness of their investments.
- Existing arrangements have done little to control leverage and excessive risk taking. Quite the contrary, banks and other financial institutions have been encouraged to use their own internal risk measurement and management to control their risk on the basis of the mistaken notion that markets price risk correctly and that it is possible, in effect, to privatize the management and control of aggregate market risk. Financial stability is a public good that is not provided by the financial markets.

4.2 Revise Basel II's Three Pillars

Reform should address all "Three Pillars" of the Basel Committee's regulations and not focus solely on pillar one. The three pillars are: minimum capital requirements, supervisory review of capital adequacy and market discipline. Within the Basel II framework, the emphasis is placed on the capital requirements that rely on banks' own internal risk management system. Market disclosure and discipline comes next. Also under Basel II, the authorities de-emphasize the traditional activities of regulators and supervisors, who enforce externally determined and sometimes non-market-based rules of regulation. The eight percent capital requirement is a minimum capital ratio. A bank's supervisor may require it to maintain a higher one. But the authorities may have no need to enforce any requirement that a bank have a higher capital ratio, due to market discipline. Since a bank's capital ratio is made public, it functions as a quick and easy measure of the bank's soundness. Banks with high capital ratios have easy access to both capital and credit. The markets punish banks with low capital ratios.

This may well seem a sensible thing to do if the purpose is to regulate an individual bank, but the effects are different in practice and in the aggregate: this package of policies accentuates rather than dampens the business cycle. It is easy to see why. The problem is not simply that a bank's capital normally rises during a boom and falls during a crisis. The problem is that the capital requirements are risk-weighted. The risk weights are functions of current and recent prices, and are thus inherently *counter-cyclical:* the risk measures fall during the boom and rise during the bust.

Then there is the problem of Basel II's effect on the diversity of investors' opinions: if every investor is using the same risk measurement and management system, the resultant lack of disagreement will make the trading of that risk impossible. The market discipline that this system encourages is loose during the boom and harsh during the bust. Banks that are doing well, that is, banks with rising capital and profitable investments that are seemingly less risky, are given more capital to spend. Banks in trouble, that is, banks with falling capital and riskier and losing investments, are starved. The effect of each bank acting in the same way is first expansionary then contractionary to an extreme degree. Everyone either increases or slows his lending at the same time. Individual banks, those whose capital ratios are known to be rising or falling the most rapidly, will be rewarded most and punished worst.

Two important counter-cyclical reforms should be introduced either to replace or to counteract the existing capital requirement's pro-cyclicality. The capital requirements themselves could be reformed to make them counter-cyclical. Provisioning should be used as a counter-cyclical policy tool. Banks should make the additions to their loan loss reserves when they make their loans. Margin requirements should be used proactively. The objective of these and similar measures is to prevent the bust by preventing the boom from getting out of hand.

4.3 Create Comprehensive Regulation

The new regulations should be comprehensive, covering all activities, instruments, markets, and institutions, including off-balance sheet items, hedge funds, and off shore centers and tax havens. Otherwise, a "shadow finance system" makes it impossible to avoid the over-leveraging and regulatory arbitrage that contributed to the current crisis. Every kind of banking and financial activity needs to be monitored, both the underlying and the derivative security brought under review, and exchange-traded as well as over-the-counter securities brought under control. Trading firms, insurance companies and pension and mutual funds must come under review. A world financial authority or global regulator to complement a reformed IMF, reconfigured as a central bank of central banks, would be needed to develop and then implement the needed regulatory reforms. Simply put, the domain of the regulator should be the same as the domain of the market.

4.4 Adopt Liquidity Measures

Serious flaws exist in the short-term money markets in which financial and nonfinancial institutions raise funds to finance their investments and other longer term activities. Every kind of institution, market, and financial system has been adversely affected by the crisis, but the market that has been affected the worst lies at the very center of the international economy: the interbank market. Central banks everywhere have taken measures to make the term interbank market liquid again, but so far without success. The reasons for these failures are not clearly understood, nor is it apparent why the interbank market has been so severely affected. The short-term money markets are in urgent need of reform.

4.5 Reduce Market Risk

Financial markets do not process information efficiently, or well. Whether this occurs because of the sort of information asymmetry problems important to Stiglitz, or because of what Keynesians and post-Keynesians would call "radical uncertainty," banks and financial markets do not allocate capital efficiently, and market-determined risk premiums provide little if any information about the underlying risks. If banks and financial markets cannot make efficient long-term investments or manage risk effectively when left to their own devices, then more effective regulation is needed quite apart from any effects it might have in preventing and abating future crises.

There is a deep flaw in how the current system manages risk, its market price and especially its credit risks. It has attempted to manage the latter through credit derivatives, that is, by creating a market not for credit but for credit risk. At issue is the encouragement that the authorities gave in the move from the first Basel capital regime to Basel II and thus the connection between the evolution of the BIS's capital regime and our current difficulties.

Under Basel II, banks can use their own internal risk measurement and management systems to determine their own capital requirements, not just for the price risks of their trading operations (this was not new), but also, and more importantly, for their counter-party – or credit – risks more generally. Using credit derivatives to shape, restructure and otherwise manage credit exposure was the private sector's rational response. Banks had already made the necessary investments in their information and trading technologies to manage price risks, so it was easy for them to use this same technology to construct and trade credit default swaps, collateralized debt obligations, and asset backed commercial paper. This is what the move to Basel II encouraged them to do, and this is what they did.

The last thing needed is a "Basel II with feeling," or in other words, a nuanced capital regime but one in which a bank's own risk modeling still plays a role. The problem is not simply the self-dealing that the policy of allowing banks to set their own risk capital encourages. Effective regulation is intrusive: it should compel the firm being regulated to act differently from the way it would behave simply to maximize its own profits and minimize its own risks. Stability is a public good, and systemic risk is an externality. Just as the latter is not measurable in terms of an individual bank's assessment of its risk, public goods are not normally something that markets produce. Macroeconomic banking and financial market stability is something that a regulator imposes.

The fact that unregulated financial markets suffer from information problems has several additional implications.

- To increase market transparency, over-the-counter trading of any derivative or structured product should be stopped, transferring whatever functions that derivative or product may have served to exchanges instead. The special purpose vehicles and other similar legal fictions that allowed banks and other financial institutions to keep such transactions off-the-book should additionally be abolished.
- Similar measures must be taken to end insider trading and conflicts of interest. Incentives, fire walls, and firms' corporate governance should be reformed.
- To prevent future financial crises and the misallocation of capital that occurs during a "mania," the monetary authorities should take asset price inflations and deflations and not just Consumer Price Index (CPI) inflations and deflations – into consideration in the conduct of their policies, including regulatory policies. There is something unsettling about how central banks have behaved in the past: their unrelenting commitment to keep CPI inflation low, combined with their apparent unwillingness to check asset inflations, produced an era characterized by a combination of low wages,

slow growth, and persistent financial instability.

Assuming that the financial system cannot be fully reformed, measures must be taken to place a ring around the system's core banking and financial institutions. The purpose is to protect the core from other less regulated sectors of the financial system that might still exist and where the informational problems continue to prevail. The problem is to control leveraging – the mobilization of the monetary system for speculative purpose – and thus to prevent the leveraged money from collapsing during a financial crisis back into its monetary base, with inevitable disruptive effects on the use of money as a means of payment. Strong regulation, coupled with generous lender-of-last-resort lending when needed, are clearly part of the long-term solution.

4.6 Adopt Fiscal Stimulus Packages

Fiscal stimulus is urgently needed to revive the underlying real economy as monetary policy is clearly caught up in what even Keynes would call a "liquidity trap." A large, rapid, and internationally coordinated fiscal expansion is needed to stimulate world demand, and it is needed immediately. This could and perhaps should be accompanied by a recycling of China's, Japan's and other countries' large external reserves – possibly through a network of regional development banks – to emerging market and developing countries in need of additional financing. But policy makers should be careful: this involves the selling of US Treasuries, which could trigger a rise in interest rates and a falling dollar.

5.1 Ends and Means: The Political Economy of Reform

The financial system of a market-based economy has four functions.

- It must mobilize any idle funds that may exist for capital market investment purposes, that is, to transfer firms' savings into investment.
- In economies such as the United States, the United Kingdom, and other developed countries where home building is financed by mortgages and consumer spending by credit cards and second mortgages, it must also finance consumption.
- A third purpose, in which emerging market and developing nations have a particular interest, is the financing of international trade and investment, and hence the financing of development.
- Finally, the financial system must allow and encourage long-term investment, particularly long-term investment in infrastructure.

Banking and financial systems and the payments systems that they include are accordingly means to ends not ends in themselves. Judged by these standards, the international financial system as it currently exists is a failure. Today's unregulated and poorly regulated financial markets cannot be relied upon to transfer retained earnings into efficient investment, finance consumption expenditures, build affordable homes, finance development or raise the monies needed for restructuring the world's various national infrastructures to come to terms with global warming and other environmental limitations.

The problem is that the international banking and financial system is not simply a mechanism for allocating goods and services. Economic relations are social relations, and the international financial system, far from being a level playing field, is a fundamentally hierarchical system in which some national financial systems are dominant over other national financial systems in a geographical arrangement that is also political. From this perspective, the international financial system transfers value in the form of interest, dividends, and other payments from one region to another.

From this perspective as well, financial crises have a disciplining function, especially given how financial crises have been solved in the past, with a division of labor between the interest-rate-reducing G10 central bankers and an austere IMF making certain that instability – no matter where it might first appear – either remains in or is transferred to the weaker financial systems, thus weakening them even further. The "pro-cyclicality" of the capital requirements should be seen in a similar light. Here, the discipline is global.

There is another factor to consider. Financial relations are always creditor-debtor relations in which, in exchange for money now, the debtor transfers more money to the creditor in the future. Since the debtor must make his payments to the creditor even if the investments made with the borrowed money are not profitable, the debtor is the subordinate member in the relation even if he too is an investor. Debtors who borrow to finance consumption simply get deeper into debt.

5.2 What Is At Stake?

These three facts – an international hierarchy of national banking systems, financial crises as disciplining mechanisms, and the creditor-debtor relations pervading the entire system – determine what is at stake in the debate over the nature of any new "international financial architecture." The allocation of resources at stake here depends upon a change in the organizational capacities of states and inter-state institutions. This new allocation cannot be made on the basis of the market alone, for instability and unfairness are inherent to free and unregulated markets. Given the connections that exist between rights and citizenship and thus between human rights and the nation state, the principle that should guide this new allocation of the world's true global regulatory resources is clear: national sovereignty within a system of international equality. The subordinate position of the emerging market and developing nations within the international financial system must come to an end.

6.1 Towards a Global Social Democracy

Agreement among reformers about the nature of today's global economic crisis and the place of the emerging market and developing countries within it, that any reforms should be counter-cyclical and strong, that financial markets are susceptible to market failures, that principles of national equality should shape the new regime, and that measures should be taken to simulate aggregate demand, does not imply unanimity about just what the "New Bretton Woods" would be or do. Two positions are discernable. On the one hand, there are those who believe that the financial market's informational difficulties can be solved by better market transparency, who are more concerned about stability than equality, and who believe that the necessary changes are minimal. On the other hand, those who mistrust lightly regulated or unregulated markets, and for whom the existing arrangements have led to serious and negative economic and social consequences, see the need for major structural change.

For the first group, the regulations promulgated by any new international market regulator should be light, and should be limited in focus to matters of macroeconomic stability, while also leaving the market to play a large role in the allocation of global savings and the financing of development. For the second group, the new regulation should be intrusive and should actively promote the development of emerging market and developing nations, while finding innovative ways to direct market outcomes toward a more equal distribution of social goods. Group one gives greater value to market relations; group two favors decommodification. It is important to remember, however, that these disagreements occur within the context of a more fundamental agreement about the need to reform the international economy and the place of emerging market and developing countries within it, and about the pace and extent of the needed reforms.

6.2 A Minimum Programme

What minimum set of principles, then, should guide the reform process moving forward? There are three.

- Any solution must take the social costs of the crisis as its starting point, because these are disproportionally affecting the developing countries, as well as the poor and labor more generally. A viable and stable global banking and financial system is a means to an end, not an end in itself, and the ends that matter are social. The merit of the banking and financial system should not be judged merely in terms of the stability that it promotes or in terms of the growth, innovation, and investment that it may encourage. The systemic arrangements should also be judged in terms of how effectively they promote social justice.

- For this reason, representative global institutions – not *ad hoc* groupings without democratic legitimacy – must be at the center of any reform effort. The IMF, BIS, and other related bodies may have a role to play in the new system, but proposals that lack democratic legitimacy will go nowhere. There is a link between the injustice and instability of the international financial system that is now unraveling and its current inability to promote stability and growth. The reforms necessary to stabilize the international economy – and to bring it back together again – must therefore take the voices of emerging market and developing countries into to account.
- Finally, these reforms must necessarily establish a new balance between the economic and the political, a new balance that favors the democratic state over the financial market, the public interest over private gain, and an accountable government over unaccountable speculation.

About the Author:

Christopher Rude is a political economist and long-standing observer of financial markets. Dr. Rude worked at the Federal Reserve Bank of New York for many years and then on Wall Street. He has a Ph.D. in economics from the New School for Social Research. He also teaches at the New School. *The author would like to thank Werner Puschra, Stephany Griffith-Jones and Sara Burke for their support and helpful input for this project.*

More information is available at

www. fes-globalization.org

Friedrich-Ebert-Stiftung
Hiroshimastrasse 17
10785 Berlin
Germany
Tel.: ++49-30-26-935-914
Fax: ++49-30-26-935-959
Roswitha.Kiewitt@fes.de
www.fes.de/globalization

Friedrich-Ebert-Stiftung
New York Office
747 Third Avenue, Suite 22B
New York, N.Y. 10017
Tel.: ++1-212-687-0208
Fax.: ++1-212-687-0261
http://www.fes-globalization.org/new_york/